Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Campbell Analyst: Colin Stevens Bill Number: AB 7

Related Bills: See legislative history Telephone: 845-3036 Introduced Date: 12/07/98

Attorney: Doug Bramhall Sponsor:

SUBJECT: Exclusion/Gain From Sale Of Capital Assets Held For 5 Years or More

SUMMARY

Under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), this bill would exclude from income any gain from the sale or exchange of a capital asset held by a taxpayer for five years or more.

EFFECTIVE DATE

As a tax levy, this bill would take effect immediately upon enactment and would apply to taxable or income years beginning on or after January 1, 1999.

LEGISLATIVE HISTORY

AB 1673, AB 2200, SB 8, SB 706 (1995/96), AB 9 (1997), SB 34, SB 37, (1999).

BACKGROUND

Under **federal law** prior to 1987, capital gains were allowed preferential tax treatment. Individuals were allowed to deduct up to 60% of net gain from the sale of capital assets held for one year or more, and corporations had a preferential tax rate applied to capital gain income. For individuals, capital losses were deductible only to the extent of capital gains plus $3,000. The **federal** provisions for favorable treatment were repealed by the 1986 Tax Reform Act. Currently, capital gains for individuals are taxed at a maximum rate of 20% while other income is taxed at a maximum rate of 39.6%. For corporations, no preferential tax rate applies to capital gain income.

Under **California law,** prior to 1987, a portion of net capital gain was, under specified circumstances, not taken into account in computing taxable income. The percent of gain not taken into account in computing taxable income depended upon the length of the asset's holding period. If an asset was held for less than one year before sale or exchange, none of the gain was excluded; if held for more than one year but less than five years, 35% of the gain was excluded; and if held for more than five years, 50% of the gain was excluded. The amount not taken into account was generally included as a tax preference item (with an exception for certain gains from small business stock). California responded to the federal repeal of preferential capital gain tax treatment in 1988 by eliminating the special "percentage of gains included" rules described in this paragraph.

Board Position:			Department Director	Date
______ S	______ NA	______ NP		
______ SA	______ O	______ NAR		
______ N	______ OUA	__X__ PENDING	**Gerald Goldberg**	**1/29/1999**

SPECIFIC FINDINGS

California law generally conforms to Internal Revenue Code (IRC) provisions relating to gain or loss on the disposition of capital assets. **Federal law** (Internal Revenue Code (IRC) Section 1221) and the Revenue and Taxation Code provide that capital assets are property other than: stock in trade or other inventory-type property held primarily for sale to customers; depreciable or real property used in a trade or business (i.e., "Section 1231 Property"); copyrights and other literary property; accounts or notes receivable acquired in the ordinary course of business; and U.S. government publications, as specified.

Generally, capital gain is realized and recognized when a capital asset is sold or exchanged and the amount realized exceeds the adjusted basis of the asset (and, in certain situations, the amount subject to recapture under federal law). Adjusted basis in a capital asset is generally determined by the cost of the asset (when capital assets are acquired in certain non-recognition transactions, adjusted basis may be a carryover or substituted basis) and is increased by further investment or decreased by allowable deductions (such as depreciation). Capital losses occur when a capital asset is sold or exchanged and the amount realized is less than the adjusted basis of the asset. Generally, a gain or loss from the sale or other disposition of property that does not qualify as a capital asset is ordinary gain or loss, and similarly, a sale or other disposition of a capital asset in a transaction that does not qualify as a "sale or exchange" also generates ordinary gain or loss.

Under recent amendments to **federal law**, the maximum tax rate applicable to net capital gains for assets held more than one year was reduced from a maximum rate of 28% to 20% and to 10% for individuals, estates, and trusts who would pay tax at the 15% marginal rate. Beginning after the year 2000, federal law reduces these maximum capital gains rate for individuals to 18% (for those who would otherwise pay 20%) and 8% (for those who would otherwise pay 15%), provided the asset has been held more than five years.

Under current **California tax law**, capital gains for corporate and noncorporate taxpayers are taxed at the same rates as ordinary income, with no reduced capital gain rate.

Federal and state laws currently allow noncorporate taxpayers to exclude 50% of the gain from certain small business stock originally issued after August 10, 1993, that is held for more than five years. The California exclusion applies only to stock acquired upon its original issuance before January 1, 1999. Both federal and state laws define “small business” and specify certain limitations (with special "targeting to California businesses" requirements in the California provisions), including that the stock be held for at least five years at the time any gain is realized in order to qualify for this special 50% exclusion. One-half of the excluded amount of gain on small business stock is treated as an alternative minimum tax (AMT) preference item. Recent federal law also allows an individual to roll over tax-free any gain from the sale of qualified small business stock held for more than six months where the taxpayer uses the proceeds to purchase other qualified small business stock within 60 days of the sale. California has not conformed to this rollover provision.

Federal and state laws allow an exclusion of the capital gain from sale of a principal residence, subject to certain limitations. An individual may exclude up to $250,000, while a married couple filing a joint return may exclude up to $500,000. This exclusion may be used only once every two years and is available only if the taxpayer owned and occupied the residence for at least two of the five years prior to the sale. No comparable exclusion is available for corporate taxpayers.

California has not conformed to the changes in federal capital gains tax rates. California taxes capital gains at the same rate as ordinary income.

Under **federal and state laws**, the length of time that a capital asset is held before its sale or other disposition is referred to as its "holding period." Holding periods generally begin on the day after the day of acquisition and end on the day of sale, exchange or other disposition. However, in some cases, such as donated property, the donee’s holding period for property acquired by gift includes the donor’s holding period if the property has the same basis for gain or loss in the hands of the donee as it would have in the donor’s hands (i.e, the holding period of the donor is "tacked" onto the holding period of the donee). Similiarly, in the case of certain non-recognition transactions where property is exchanged, such as tax-free exchanges and certain corporate acquisitions where gain is realized but gain recognition is deferred, the holding period of the property received includes the period during which the property surrendered was held.

A noncorporate taxpayer may deduct capital losses only to the extent of capital gains plus the lesser of either $3,000 ($1,500 for married individuals filing separate returns) or the excess of losses over gains. Corporations may deduct capital losses only to the extent of capital gains. **Federal law** generally permits a three-year carry-back and a five-year carry-forward for excess capital losses. **California law,** however, permits only a five-year carry-forward for excess capital losses.

Under the PITL and B&CTL, **AB 7** would allow taxpayers to exclude from gross income 100% of the gain from the sale or exchange of any capital asset that is sold after January 1, 1999, and which has been held by the taxpayer for five years or more.

A “capital asset” would be defined by reference to Section 1221 of the Internal Revenue Code.

Policy Considerations

Prior preferential treatment for capital gains allowed only a portion of the **net** gain (capital gains minus capital losses) to be excluded from taxation. This bill would exclude 100% of **any** gain from the sale or exchange of a capital asset held for more than five years, rather than following long-standing federal and state law requiring the offsetting of capital losses from such assets against gains before determining the amount of gain eligible to be excluded. As a result, any gain from the sale or exchange of a capital asset held over five years would be excluded from income and 100% of all capital losses (subject to the limitations discussed above) would be eligible to be included in computing taxable income.

This bill would create an additional difference between federal and state laws, requiring that an additional adjustment be made, increasing the complexity of preparing a California income tax return.

This bill could provide an incentive for taxpayers to classify business assets (i.e., Section 1231 assets) as capital assets in order to take advantage of the exclusion. Further, these provisions could encourage taxpayers to engage in activities that have the effect of converting ordinary income into capital gain. Moreover, without further rules provided in the bill, it would require extensive audit activity for department staff to determine whether such conversion is occurring.

AMT was established to ensure that taxpayers with economic income pay some amount of tax. One-half of the existing small business stock exclusion is an AMT preference item. Prior to the Tax Reform Act of 1986, the amount of any capital gain deduction (for federal purposes) or exclusion (for state purposes) also was a tax preference item. This bill does not treat the proposed capital gain exclusion as a tax preference item, thereby further enhancing the value of this exclusion and further encouraging the possible behavorial changes described in the preceding paragraph.

The bill does not specify whether part-year and nonresidents who pay California tax would exclude from income the entire amount of the capital gain or only the percentage of income attributable to California.

The bill does not specify treatment of sales or exchanges between related parties or how the acquisition date should be determined when an asset is obtained with a carryover of holding periods.

California courts have held that, unless specifically provided in a bill, capital assets purchased prior to the enactment of a bill will receive the benefit provided under that section. In the case of Lennane V. FTB, (9 Cal.4th 263), the California Supreme Court held that gain on the sale of small-business stock was not subject to an acquisition date limitation. Therefore, unless otherwise specifically provided, this bill would exclude from California taxation gains from the sale or exchange of capital assets owned by taxpayers prior to the enactment of this bill as well as those acquired after the passage of this bill.

Although exempt organizations would receive an exclusion from income for any gain from the sale of a capital asset held five years or more, this bill would not exempt those organizations from paying tax on unrelated business income generated from the sale of capital assets.

AB 7 would exclude capital gains from assets as defined in IRC Section 1221 that have been held for five years or more. However, capital gain can also be generated from the sale of non-capital depreciable assets or real property used in a trade or business (i.e., Section 1231 assets).

Implementation Considerations

It is unclear what portion of capital gains would be excluded if an asset held for five years had improvements made at some time during the holding period. For example, if a building purchased for $200,000 and held for five years was remodeled for $800,000 during the third year of the holding period and sold for $2 million after the fifth year, it is unclear whether the full $1 million would be exempt from gain, or only the $200,000 initially invested five years ago.

The bill as drafted refers to "gain from the sale or exchange of a capital asset," but does not condition application of the exclusion on "**recognition**" of such gain. As a result, if gain is "**realized,**" but not "**recognized,**" in a non-recognition transaction (for example, an exchange of stock in a corporate acquisition), it is unclear whether the provision would apply.

The B&CTL contains a reference to "taxable" years beginning on or after January 1, 1999. However, the correct term for the B&CTL is "income" years. Amendment 1 would correct this.

Once the considerations above are resolved, the department could implement this bill during its annual update process.

FISCAL IMPACT

Departmental Costs

The department's costs to administer this bill are difficult to determine, but are anticipated to be minor once the implementation considerations are resolved. However, additional printing costs of $78,400 would be required to expand the Form 540 booklet in order to include this bill's provisions. The other booklets have sufficient space and would not need additional pages.

Tax Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue losses.

Estimated Revenue Impact of AB 7 As Introduced 12/7/98 [$ In Billions]			
	1999-00	2000-01	2001-02
Exclusion	($1.7)	($1.4)	($1.4)
Behavior	($0.1)	($0.2)	($0.2)
Total	($1.8)	($1.6)	($1.6)

The bill would be effective with taxable or income years beginning on or after January 1, 1999, with enactment assumed after June 30. This estimate assumes the exclusion from income would apply to transactions occurring on or after January 1, 1999, regardless of acquisition date (provided the asset has been held for five years or more). The behavioral impact represents taxpayers that would hold assets longer than otherwise to qualify for the proposed exclusion.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

The number of capital asset transactions resulting in gains, the amount of excluded gains, and effective tax rates of taxpayers with such transactions would determine the revenue impact of this bill.

The revenue impact of the capital gain exclusion was based on capital asset sample data (1996 base). Revenue losses are estimated as the difference between tax liabilities under current and proposed laws. The estimate reflects a recalculation of each taxpayer's separate capital gain transactions, reduced taxable income, any capital loss limitation, and marginal tax rate. Results from sample data were weighted statistically to the population. Losses for 1996 were projected to later years by the most recent capital gain growth rates as provided by the Department of Finance (December 1998). The corporate impact is included in the estimate above and was estimated to be 5% to 10% of the PIT impact.

It is likely some taxpayers would decide to hold assets for a longer period of time to avail themselves of the exclusion proposed in this bill. A taxpayer that is otherwise motivated to sell an asset may decide to delay the sale to meet the required five-year holding period and qualify for the 100% exclusion of gains. The additional revenue loss from this predictable behavioral response is based on departmental data regarding capital asset holding periods.

BOARD POSITION

Pending.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 7
As Introduced

AMENDMENT 1

On page 2, line 10, strike "taxable" and insert:

income